Client Code 405

INDUSTRIAL COMMISSION

BISMARCK, NORTH DAKOTA

Department of Mineral Resources
Lignite Research Program
Oil and Gas Research Program
Renewable Energy Program
Pipeline Authority
Transmission Authority

Audit Report

For the Biennium Ended
June 30, 2013

ROBERT R. PETERSON
STATE AUDITOR

Office of the State Auditor
Division of State Audit

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BISMARCK, NORTH DAKOTA 58505

Transmittal Letter

June 30, 2014

The Honorable Jack Dalrymple, Governor

Members of the North Dakota Legislative Assembly

Ms. Karlene Fine, Executive Director, Industrial Commission

We are pleased to submit this audit of the Industrial Commission for the biennium ended June 30, 2013. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Angela Klubberud, CPA. Dina Cashman was the staff auditor. Cindi Pedersen, CPA was the audit manager. Inquiries or comments relating to this audit may be directed to the audit manager by calling (701) 328-2241. We wish to express our appreciation to Karlene Fine, Lynn Helms, and their staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

Robert R. Peterson
State Auditor

Executive Summary

Introduction

The North Dakota Industrial Commission was created by the Legislature in 1919 to conduct and manage, on behalf of the state, certain utilities, industries, enterprises, and business projects established by state law. The members of the Industrial Commission are the Governor, Attorney General, and the Agriculture Commissioner of the state.

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies. Those items and the Office of the State Auditor's responses are noted below.

Responses to LAFRC Audit Questions

1. *What type of opinion was issued on the financial statements?*

   Financial statements were not prepared by the Industrial Commission in accordance with generally accepted accounting principles so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unmodified opinion was issued.

2. *Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?*

   Other than our findings addressing "lack of fixed asset inventory" (page 13), the Industrial Commission was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

3. *Was internal control adequate and functioning effectively?*

   Yes.

4. *Were there any indications of lack of efficiency in financial operations and management of the agency?*

   No.

5. *Has action been taken on findings and recommendations included in prior audit reports?*

   The Industrial Commission has implemented all recommendations included in the prior audit report.

6. *Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.*

   Yes, a management letter was issued and is included on page 14 of this report, along with management's response.

LAFRC Audit Communications

7. *Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.*

   There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

8. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

   The Industrial Commission's financial statements do not include any significant accounting estimates.

9. *Identify any significant audit adjustments.*

   Significant audit adjustments were not necessary.

10. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

    None.

11. *Identify any serious difficulties encountered in performing the audit.*

    None.

12. *Identify any major issues discussed with management prior to retention.*

    This is not applicable for audits conducted by the Office of the State Auditor.

13. *Identify any management consultations with other accountants about auditing and accounting matters.*

    None.

14. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

    ConnectND Finance, Human Resource Management System (HRMS), and the Risk Based Data Management System (RBDMS) are high-risk information technology systems critical to the Industrial Commission.

Audit Objectives, Scope, and Methodology

Audit Objectives

The objectives of this audit of the Industrial Commission for the biennium ended June 30, 2013 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the highest risk areas of the Industrial Commission's operations and is internal control adequate in these areas?

2. What are the significant and high-risk areas of legislative intent applicable to the Industrial Commission and are they in compliance with these laws?

3. Are there areas of the Industrial Commission's operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the Industrial Commission is for the biennium ended June 30, 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Industrial Commission has operations in the following locations. Each location was included in the audit scope:

- Administrative office in the State Capitol.
- Department of Mineral Resources office, Bismarck.
- Core and Sample Library, Grand Forks.
- Regional offices in Dickinson, Minot, and Williston.

Audit Methodology

To meet the objectives outlined above, we:

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report and reviewed management's discussion and analysis of the financial statements.
- Performed detailed analytical procedures including computer-assisted auditing techniques. These procedures were used to identify high-risk transactions and potential problem areas for additional testing.
- Tested internal control and compliance with laws and regulations which included selecting representative samples to determine if controls were operating effectively and to determine if laws were being followed consistently. Non-statistical sampling was used and the results were projected to the population. Where applicable, populations were stratified to

ensure that particular groups within a population were adequately represented in the sample, and to improve efficiency by gaining greater control on the composition of the sample.

- Interviewed appropriate agency personnel.
- Queried the ConnectND (PeopleSoft) system. Significant evidence was obtained from ConnectND.
- Observed Industrial Commission's processes and procedures.

In aggregate there were no significant limitations or uncertainties related to our overall assessment of the sufficiency and appropriateness of audit evidence.

Management's Discussion and Analysis

The accompanying financial statements have been prepared to present the Industrial Commission's revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

The following management discussion and analysis was prepared by the Industrial Commission's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of this supplementary information to ensure it does not conflict with the knowledge we gained as part of our audit.

For the biennium ended June 30, 2013, operations of the Industrial Commission were primarily supported by appropriations from the state's general fund and special funds. This is supplemented by interest income and fees credited to the agency's operating fund.

Financial Summary

"Total Revenues and Other Sources" for the Industrial Commission were $6,766,919 in fiscal year 2013 compared to $9,929,559 in fiscal year 2012. Revenues unique to the Commission include revenues from an investment made through the Lignite Research Program in the Dakota Gasification Company (DGC). The provisions of the Investment Agreement state the annual repayment to the Lignite Research Fund is linked to a formula based percentage of DGC's net income. DGC had profitable years in both 2012 and 2013 although revenues were less in 2013. Fines were higher in 2012 as a result of enforcement actions in response to oil, water, and gas releases caused by well bore and reserve pit failures. Significant rule changes have been implemented to eliminate subsequent similar failures. The remaining revenues came from federal funds, investment earnings on the research funds, charges for services, permits, and fees. With the increased oil and gas activity in the state, there has been an increase in income from charges for publication sales, permits and fees, and miscellaneous revenue.

"Transfers in" were lower in 2013 than in 2012. State law authorizes that 2% of the revenues from the oil and gas gross production tax and oil extraction tax, up to $4 million per biennium, must be deposited monthly in the oil and gas research fund. With the state receiving increased revenues from these two taxes the entire $4 million in revenues was received during fiscal year 2012.

Total expenditures for the Industrial Commission were $11, 801,302 for the year ended June 30, 2012 as compared to $13,032,679 for the prior year (2011). In 2013 there was an increase to $15,045,655 based partially on salaries and benefits. By the end of the fiscal year 2013 the positions authorized by the Legislature in 2011 had all been filled. Because of the high level of oil and gas activity in the western part of the state the Department of Mineral Resources has needed to increase staffing in order to meet regulatory requirements. This need for additional staffing has been discussed in prior audits and is expected to continue until 2020. Grant expenditures increased in 2013 as a result of when work was completed under the research programs.

The Commission's oversight also includes the Abandoned Oil and Gas Reclamation Fund. On June 30, 2013 the balance in this fund was $2,308,452. Revenues to the fund must include:

a. Fees collected by the Oil and Gas Division of the Industrial Commission for permits or other services.
b. Moneys received from the forfeiture of drilling and reclamation bonds.
c. Moneys received from any federal agency for the purpose of this section.
d. Moneys donated to the Commission for the purposes of this section.
e. Moneys received from the state's Oil and Gas Impact Fund.
f. Moneys recovered under the provisions of Section 38-08-04.8.
g. Moneys recovered from the sale of equipment and oil confiscated under section 38-08-04.9.
h. Moneys transferred from the Cash Bond Fund under Section 38-08-04.11.
i. Such other moneys as may be deposited in the fund for use in carrying out the purposes of plugging or re-plugging of wells or the restoration of well sites.

Monies in this fund are appropriated and must be used and disbursed solely for the purpose of defraying the costs in carrying out the plugging or re-plugging of wells, the reclamation of well sites, and all other related activities. The 2013 Legislature increased the funding level for this fund and expanded the types of projects for which these funds can be utilized.

Analysis of Significant Changes in Operations

Oil and gas development increased significantly during fiscal years 2012 and 2013. In December 2011 there were 200 drilling rigs and 6,561 producing wells operating in the state—production for calendar year 2011 was 153,059,263 barrels of oil. In December 2012 there were 8,369 producing wells operating in the state—production for calendar year 2012 was 243,287,285 barrels of oil. In calendar year 2012 the drilling rig count peaked at 218 in May and averaged 200 drilling rigs with the count being 183 in December of 2012. Since that time the rig count has varied from 180 to 195 and the producing well count and oil production have continued to increase. The high level of activity creates significant workload for the Industrial Commission. This will be an ongoing challenge for the Commission and its staff.

Analysis of Significant Variances - Budgeted and Actual Expenditures

The Commission continued to see unexpended appropriation authority in its grants line item. This is a result of the timing of payments for Lignite Research Program Projects. Payments are made on projects based on work accomplished. Because of uncertainty at the federal level on energy issues, two lignite projects have been delayed. The Commission has committed Lignite Research Fund dollars in the approximate amount of $14 million for two significant lignite projects. These projects are the Great Northern Power Development Project near South Heart and the American Lignite Energy Project in McLean County. If issues at the federal level are resolved we are hopeful that work could proceed and the funding would be utilized.

Financial Statements

Statement of Revenues and Expenditures

		June 30, 2013		June 30, 2012
Revenues and Other Sources:				
Dakota Gasification Company Loan Revenue	$	464,100	$	644,280
Fines		175		592,080
Charges for Sales and Services		646,696		443,033
Permits and Fees		395,236		319,652
Federal Revenue		111,897		129,368
Interest and Investment Earnings		137,608		98,428
Miscellaneous Revenue		443,851		24,343
Donations		140,500		
Transfers In		4,426,856		7,678,375
Total Revenues and Other Sources	$	6,766,919	$	9,929,559
Expenditures and Other Uses:				
Salaries and Benefits	$	6,914,570	$	5,670,574
Grants		5,323,710		3,642,081
Professional Services		790,150		735,979
Travel		565,622		521,971
Rentals/Leases – Building		284,697		477,466
Data Processing/Communications		171,090		158,949
Supplies		168,349		138,630
Equipment		362,590		126,240
Professional Development		63,254		38,828
Other Operating Expenses		236,623		190,584
Transfers Out		165,000		100,000
Total Expenditures and Other Uses	$	15,045,655	$	11,801,302

Statement of Appropriations

For The Biennium Ended June 30, 2013

Expenditures by Line Item:	Original Appropriation	Adjustments	Final Appropriation	Expenditures	Unexpended Appropriation
Salaries and Benefits	$ 12,211,620	$ 619,154	$ 12,830,774	$ 12,017,943	$ 812,831
Operating Expenses	3,493,744	1,124,818	4,618,562	3,341,986	1,276,576
Grants	19,971,300		19,971,300	5,559,595	14,411,705
Carbon Dioxide Storage Admin.	532,000		532,000	532,000	
Mineral Resources Contingency	743,972	(743,972)			
Renewable Energy Development	1,500,000		1,500,000	1,500,000	
Totals	$ 38,452,636	$ 1,000,000	$ 39,452,636	$ 22,951,524	$ 16,501,112
Expenditures by Source:					
General Fund	$ 17,075,613	$ 1,000,000	$ 18,075,613	$ 16,687,087	$ 1,388,526
Other Funds	21,377,023		21,377,023	6,264,437	15,112,586
Totals	$ 38,452,636	$ 1,000,000	$ 39,452,636	$ 22,951,524	$ 16,501,112

Appropriation Adjustments:

The $619,154 increase in the salaries and benefits line item was approved by the Emergency Commission in accordance with Senate Bill 2015, section 16, of the 2011 Session Laws for the purpose of hiring additional full-time equivalent positions when specific thresholds are met related to the drilling rig count and total number of oil wells in the state.

$1,000,000 of the increase in operating expenses line item was pursuant to Senate Bill 2371, section 28, of the 2011 Special Session Laws for the purpose of defraying expenses associated with possible litigation and other administrative proceedings involving the United States environmental protection agency's effort to regulate hydraulic fracturing. The remaining $124,818 increase was approved by the Emergency Commission in accordance with Senate Bill 2015, section 16, of the 2011 Session Laws for the purpose of hiring additional full-time equivalent positions when specific thresholds are met related to the drilling rig count and total number of oil wells in the state.

The $743,972 reduction in the mineral resources contingency line item was pursuant to Senate Bill 2015, section 16, of the 2011 Session Laws for the purpose of hiring additional full-time equivalent positions when specific thresholds are met related to the drilling rig count and total number of oil wells in the state.

Expenditures Without Appropriations Of Specific Amounts:

Fossil Excavation and Restoration Fund has a continuing appropriation authorized by NDCC section 54-17.4-09.1 ($296,622 of expenditures for this biennium).

Renewable Energy Development Fund has a continuing appropriation authorized by NDCC section 54-63-04 ($2,107,047 of expenditures for this biennium).

Oil and Gas Research Fund has a continuing appropriation authorized by NDCC section 57-51.1-07.3 ($2,569,449 of expenditures for this biennium).

Carbon Dioxide Storage Facility Administrative Fund has a continuing appropriation authorized by NDCC 38-22-14 ($185,691 of expenditures for this biennium).

Pipeline Authority Administrative Fund has a continuing appropriation authorized by NDCC section 54-17.7-11 ($293,820 of expenditures for this biennium).

Cash Bond Fund has a continuing appropriation authorized by NDCC section 38-08-04.11 ($176,550 of expenditures for this biennium).

Cartographic Products Fund has a continuing appropriation authorized by NDCC section 54-17.4-10 ($375 of expenditures for this biennium).

Global Positioning System Community-Base Station Fund has a continuing appropriation authorized by NDCC section 54-17.4-12 ($424 of expenditures for this biennium).

Oil and Gas Reservoir Data Fund has a continuing appropriation authorized by NDCC section 38-08-04.6 ($646,998 of expenditures for this biennium).

Geo Data Preservation Fund has a continuing appropriation authorized by NDCC section ($10 of expenditures for this biennium).

Geo Mineral Coal Exploration Fund has a continuing appropriation authorized by NDCC section 38-21-01 ($203 of expenditures for this biennium).

Abandoned Oil and Gas Reclamation Fund has a continuing appropriation authorized by NDCC section 38-08-04.5 ($82,804 of expenditures for this biennium).

Internal Control

In our audit for the biennium ended June 30, 2013, we identified the following areas of the Industrial Commission's internal control as being the highest risk:

Internal Controls Subjected to Testing:

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls effecting the safeguarding of assets.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.

The criteria used to evaluate internal control is published in the publication *Internal Control – Integrated Framework* from the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered necessary based on our assessment of audit risk. We concluded internal control was adequate.

Auditors are required to report deficiencies in internal control that are significant within the context of the objectives of the audit. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect: (1) misstatements in financial or performance information; (2) violations of laws and regulations; or (3) impairments of effectiveness or efficiency of operations, on a timely basis. Considering both qualitative and quantitative factors, we did not identify any significant deficiencies in internal control. However, we noted other matters involving internal control that we have reported to management of the Industrial Commission in a management letter dated June 30, 2014.

Compliance With Legislative Intent

In our audit for the biennium ended June 30, 2013, we identified and tested the Industrial Commission's compliance with legislative intent for the following areas we determined to be significant and of higher risk of noncompliance:

- Compliance with the Industrial Commission's jurisdiction and authority to enforce the provisions related to the control of gas and oil resources (North Dakota Century Code section 38-08-04).
- Compliance with the Industrial Commission's jurisdiction and authority to enforce the provisions related to the control of geophysical exploration (North Dakota Century Code section 38-08.1)
- Proper use of the following legally restricted funds:
  - Renewable Energy Development fund.
  - Oil and Gas Research fund.
  - Pipeline Authority Administration fund.
  - Cash Bond fund.
  - Lignite Research fund.
  - Oil and Gas Reservoir fund.
- Compliance with appropriation laws.
- Statutory authority for investments and the proper utilization of the Bank of North Dakota for processing credit card processing.
- Application of proper statutory rates relating to revenue and deposit into proper funds.
- Compliance with OMB's Purchasing Procedures Manual.
- Travel-related expenditures are made in accordance with OMB policy and state statute.
- Proper authorization of petty cash funds.
- Adequate blanket bond coverage of employees (NDCC section 26.1-21-08).
- Compliance with fixed asset requirements including record-keeping.
- Compliance with payroll-related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.

The criteria used to evaluate legislative intent are the laws as published in the *North Dakota Century Code* and the *North Dakota Session Laws*.

Government Auditing Standards requires auditors to report all instances of fraud and illegal acts unless they are inconsequential within the context of the audit objectives. Further, auditors are required to report significant violations of provisions of contracts or grant agreements, and significant abuse that has occurred or is likely to have occurred.

The results of our tests disclosed an instance of noncompliance that is required to be reported under *Government Auditing Standards*. This finding is described below. Other than this finding, we concluded there was compliance with the legislative intent identified above. We also noted certain inconsequential instances of noncompliance that we have reported to management of the Industrial Commission in a management letter dated June 30, 2014.

Lack of Fixed Asset Inventory (Finding 13-1)

Condition:
The Industrial Commission did not take an annual physical inventory of their fixed assets as required by North Dakota Century Code (NDCC) section 44-04-07 during the two years under audit.

Criteria:
As per NDCC 44-04-07, state agencies are required to maintain a complete and current inventory record of all property of sufficient value and permanence by completing an annual physical inventory.

Cause:
The Industrial Commission oversight was due to staff changing offices and a lack of time by staff.

Effect or Potential Effect:
Possible misappropriation of state assets.

Recommendation:

We recommend the Industrial Commission perform an annual physical inventory of fixed assets in accordance with NDCC section 44-04-07.

Industrial Commission Response:

The Industrial Commission agrees with the finding and recommendation. At the time, the Industrial Commission did not have enough personnel assigned to the physical inventory to complete the inventory according to State requirements. The inventory process was initiated, but our ability to affect a timely inventory process was hindered by personnel turnover coupled with the growth of the Department and the rapidly expanding oil and gas industry in the state. For example, during this time period, we relocated our Dickinson District field office and also expanded the DMR Bismarck offices. With these required office expansions and personnel resource turnover, the inventory took longer than normal to complete. The 2013 inventory was completed, although well after the deadline for completion. A full reconciliation of fixed assets was achieved once the inventory was completed. In order to meet this requirement in the future the Industrial Commission will be requesting an Accounting\Budget Specialist (25% time allocation) to assist with the physical inventory and reconciliation process.

Management Letter (Informal Recommendations)

June 30, 2014

Ms. Karlene Fine
Executive Director
Industrial Commission
600 E Boulevard Avenue
Bismarck, ND 58505

Dear Ms. Karlene Fine:

We have performed an audit of the Industrial Commission for the biennium ended June 30, 2013, and have issued a report thereon. As part of our audit, we gained an understanding of the Industrial Commission's internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted certain conditions we did not consider reportable within the context of your audit report. These conditions relate to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendations to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if these recommendations have been implemented, and if not, we will reconsider their status.

The following present our informal recommendations.

REVENUE

Informal Recommendation 13-1: We recommend the Industrial Commission reconcile the total revenue received from the federal government to the total revenue recorded in the state's accounting system.

Informal Recommendation 13-2: We recommend the Industrial Commission reconcile permits issued in the Risk Based Data Management System to permit revenue recorded in the state's accounting system.

ACCOUNTS PAYABLE/EXPENDITURES

Informal Recommendation 13-3: We recommend the Industrial Commission code expenditures to the proper appropriation class.

PAYROLL

Informal Recommendation 13-4: We recommend the Industrial Commission update their policy for recruitment and retention bonuses to properly reflect the positions that receive these bonuses.

LEGISLATIVE INTENT

Informal Recommendation 13-5: We recommend the Industrial Commission follow OMB policies for honorariums and taxable meals.

Informal Recommendation 13-6: We recommend the Industrial Commission perform a fraud risk assessment at least every biennium in accordance with OMB Policy.

OPERATIONAL

Informal Recommendation 13-7: We recommend the Industrial Commission review and approve the prior meeting's minutes.

Informal Recommendation 13-8: We recommend the Division of Oil and Gas:

- Ensure field inspections of well sites are completed timely and within the timeframe goals established by the agency
- Document supervisory review of field inspection results to ensure documentation is adequate, conclusions are appropriate, and any violations are followed-up on in a timely manner.
- Document management analysis of violations found to determine if any changes to operations at the agency, North Dakota Century Code, or North Dakota Administrative Code need to be made or proposed.

Informal Recommendation 13-9: We recommend the Division of Oil and Gas have an independent review and approval of all permits issued.

Management of the Industrial Commission agreed with these recommendations.

I encourage you to call myself or an audit manager at 328-2241 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,

Angela Klubberud, CPA
Auditor in-charge

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